NOTES

Unrealized Gain and Loss and Dividend Law

The striking features of the legal field described in the title above are the confusion of statutes relating to it,[1] the paucity of cases on point,[2] and the existence, nevertheless, of a few fixed rules which are said to govern decisions. These rules are: (1) Unrealized losses and gains in *fixed* assets are disregarded in computing the fund available for cash dividends.[3] In other words, the assets will be carried at cost less depreciation,[4] regardless of changes in market value. Unrealized gain may be the basis for share dividends.[5] Possibly unrealized loss may be the basis for a reduction of capital stock,[6] but such a reduction is never discussed as either a possible or necessary corollary to the share dividend. (2) Unrealized losses in *current* assets must be taken into account before payment of any dividend.[7] Unrealized gains are disregarded for all purposes. The accounting phrase is, "current assets must be carried at cost or market whichever is lower."

Statutes define the fund available for dividends as the surplus of assets over liabilities including capital stock,[8] profits of the business,[9] or one of several combinations of the two.[10] Yet courts and commentators, with rare exceptions,[11] apply the rules outlined above to cases arising under every type of statute.[12] More than enthusiasm for a rule of thumb lies behind such indiscriminate lawmaking. The confusion of the statutes, which often combine both tests in a single clause, suggests that there is no clear legislative intent behind any particular form of words.[13] Furthermore, there are so few relevant cases throughout the country that the court must either brave the "case of first impression," or disregard statutory distinctions to invoke the comforting analogies of holdings in other states.

This dearth of authority is both difficult to understand and unfortunate. The amount of wealth distributed each year as dividends indicates the desirability of a developed technique for their regulation.[14] In addition, in the modern corporation management frequently owns common

1. See section 5, page 344 *infra*.
2. See Randall v. Bailey, 23 N. Y. S. (2d) 173, 178 (Sup. Ct. 1940); DODD AND BAKER, CASES ON BUSINESS ASSOCIATIONS (1940), Note on Unrealized Diminution in Value of Fixed Assets; Intangibles, 1105, 1108. This phase of the problem is discussed in sections 1 and 2, pp. 339 and 340 *infra*.
3. 11 FLETCHER, CORPORATIONS (rev. ed. 1932) § 5345.
4. For a discussion of this method of accounting see section 3, page 341 *infra*.
5. DODD AND BAKER, *op. cit. supra* note 2, Note on Unrealized Appreciation of Assets, 1118, 1119. This is by implication allowed in Pennsylvania by statute, 15 PA. STAT. ANN. (Purdon, 1938) § 2852-701 (A).
6. Note (1935) 44 YALE L. J. 1025, 1026.
7. GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE (1932) 184.
8. E. g., OHIO CODE ANN. (Baldwin 1940) § 8623-38. See general discussion of statutes, section 5, p. 344 *infra*.
9. CAL. CIV. CODE (Deering 1937) § 346.
10. DEL. REV. CODE (1935) c. 65, § 34.
11. Weiner and Bonbright, *Anglo-American Dividend Law: Surplus and Profit* (1930) 30 COL. L. REV. 954, 977.
12. Peters v. U. S. Mortgage Company, 13 Del. Ch. 11, 18, 114 Atl. 598, 602 (Ch. 1921), discussed in KEHL, CORPORATE DIVIDENDS (1941) 60; Note (1936) 35 MICH. L. REV. 286, 288.
13. (1941) 89 U. OF PA. L. REV. 822. This is a discussion of Randall v. Bailey, 23 N. Y. S. (2d) 173 (Sup. Ct. 1940), in which the court made a valiant effort to ascertain legislative intent from the changes in wording from one statute to the next.
14. 2 DEWING, FINANCIAL POLICY OF CORPORATIONS (4th ed. 1941) 774.

shares.[15] The temptation to pay unjustified dividends is obvious. The theoretical control in the votes of other shareholders has actually passed to the same management group.[16] The only curb left for a minority shareholder is his power to enjoin or rescind an improper declaration of dividends.[17]

The contrast between the importance of the subject and the meagre and unsatisfactory authority thereon invites investigation. But research does not lead to a logically symmetrical analysis. It can do no more than isolate a few of the factors which have affected the decided cases and proposed theories. An attempt to impose on these factors a fixed order of importance would fail because of the heterogeneous elements of law, economics, and accounting involved in every case. Therefore, this note will merely discuss the problems and attempt to show the roots of each.

1. *The Nature of the Legal Remedy*

The paucity of cases may be explained partly by the procedural difficulties facing the plaintiff.[18] In the first place, of course, he can seldom force payment of a dividend against the directors' discretion; he is normally confined to an attack on a dividend paid or planned. The number of possible combinations of litigants is large. Plaintiffs may include the corporation,[19] a shareholder suing for it,[20] a creditor,[21] a trustee in bankruptcy suing in either capacity,[22] a receiver, or even the state suing in *quo warranto*.[23] Recovery may be sought from either shareholders[24] or directors.[25] Where directors are defendants, the action may be for an injunction or for damages. In every case there is one or more procedural difficulties involved.

Dissolution or insolvency is a condition precedent to a creditor's right to recover.[26] Furthermore, he must decide whether to sue separately or for the benefit of others.

A shareholder suing for the corporation must join both the corporation and the directors. Again procedural difficulties may arise.[27]

A trustee in bankruptcy must choose whether to sue as corporation or creditor under applicable state statutes, and if forced to the latter, often faces the theory that creditors' rights are personal, or must be exercised as a group.[28]

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15. Note (1940) 49 YALE L. J. 492, 494, n. 7.
16. BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 90-118.
17. This theory is developed at length in Note (1940) 49 YALE L. J. 492.
18. Note (1940) 49 YALE L. J. 492, 498, n. 22. A full discussion of the material included in this section appears in KEHL, *op. cit. supra* note 12, cc. 7 and 8.
19. E. g., Southern California Home Builders v. Young, 45 Cal. App. 679, 188 Pac. 586 (1920).
20. E. g., Kahle v. Mount Vernon Trust Co., 22 N. Y. S. (2d) 454 (Sup. Ct. 1940).
21. E. g., Appleton v. American Malting Co., 65 N. J. Eq. 375, 54 Atl. 454 (1903).
22. The trustee succeeds to all causes of action which the bankrupt corporation could have exercised under § 70a(5) of the Bankruptcy Act, 11 U. S. C. A. § 110a(5) (Supp. 1940). He can set aside a transfer which was voidable as to any creditors under § 70e, 11 U. S. C. A. § 110e (Supp. 1940).
23. State v. Bray, 323 Mo. 562, 20 S. W. (2d) 56 (1929).
24. KEHL, *op. cit. supra*, note 12, c. 8.
25. *Id.* c. 7.
26. *Id.* at 260.
27. Note (1940) 49 YALE L. J. 492, 498, n. 22.
28. KEHL, *op. cit. supra* note 12, 260-262.

An action against shareholders faces their immunity from suit unless they received the dividend with knowledge of its illegality.[29] There is also the problem of whether the plaintiff can invoke equity jurisdiction for a class suit or must sue each defendant separately at law.[30] Modern statutes may postpone shareholders' liability until it has been determined that directors are either not liable or judgment-proof.[31]

Directors, when sued, can evoke the defense of good faith or due care[32] and even an added presumption that they acted in good faith.[33] This makes the plaintiff prove not only that the dividend was in fact unjustified, but that the directors' state of mind in declaring it was reprehensible, a staggering burden. Also in suits against directors an injunction is theoretically possible,[34] though practically it is difficult for an outsider to unearth from the accounts even enough evidence to justify a suit or to support a preliminary injunction before the dividend becomes an accomplished fact.[35] Therefore, as a practical matter the suit will usually be for recovery rather than injunction. Yet it seems possible that the court will tend to view the action for recovery as tardy and to penalize the plaintiff for not having acted sooner to prevent the wrong.[36]

2. *Difficulties of Proof*

A plaintiff who challenges a dividend faces, in addition to the intricacies of legal remedy, obstacles inherent in the nature of the material with which he deals. The first is the reverence of the court for standard accounting methods.[37] Accountants agree that fixed assets should be carried at cost less a charge for depreciation[38] which is designed merely to spread that cost over the expected life of the asset and does not pretend to reflect fluctuations in market value or purchasing power.[39] This system does not show what the plaintiff would call "the true worth" of the asset. To establish that true worth, the plaintiff will have to adopt another accounting method,[40] and will have to convince the court of its superiority. This is a large task, since the court is rarely sufficiently versed in accounting to form its own opinion, and if it turns to accountants for advice, it is met with virtually unanimous endorsement of the system which the plaintiff attacks.[41]

If the plaintiff chooses a more direct way of exposing the change in value which he must allege as the foundation of his case, he meets other obstacles. He offers testimony that the same assets were carried at a

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29. McDonald v. Williams, 174 U. S. 397 (1899).

30. Hale v. Allinson, 188 U. S. 56 (1903).

31. UNIFORM BUSINESS CORPORATION ACT § 25, 9 U. L. A. 77.

32. DODD AND BAKER, *op. cit. supra* note 2, Note on Good Faith and Due Care as Defenses, 1164.

33. Notes (1928) 55 A. L. R. 8, 145 (cited in Gallagher v. N. Y. Dock Co., 19 N. Y. S. (2d) 789, 799 (Sup. Ct. 1940).

34. Only two cases have been found in which plaintiff sought an injunction for this reason, Washburn v. National Wallpaper Co., 81 Fed. 17 (C. C. A. 2d, 1897); Hyams v. Old Dominion Copper Mining and Smelting Co., 82 N. J. Eq. 507, 89 Atl. 37 (Ch. 1913).

35. *See* Gallagher v. N. Y. Dock Co., 19 N. Y. S. (2d) 789, 801 (Sup. Ct. 1940). The court mentions that plaintiff spent 14 years examining the corporate books.

36. *See* (1941) 89 U. OF PA. L. REV. 822, 823.

37. *See* Gallagher v. N. Y. Dock Co., 19 N. Y. S. (2d) 789, 806 (Sup. Ct. 1940).

38. GRAHAM AND KATZ, *op. cit. supra* note 7, 184; Note (1936) 35 MICH. L. REV. 286, 288.

39. Weiner and Bonbright, *Theory of Anglo-American Dividend Law: Surplus and Profits* (1930) 30 COL. L. REV. 330, 344, 351.

40. See discussion in section 3, p. 341 *infra*.

41. See note 38 *supra*.

different value in making out the corporation's tax returns [42] or in a petition for reorganization.[43] The court rejects the testimony on the grounds that values may be different for different purposes, or, more realistically, that it is natural for directors to mark assets down in dealing with tax authorities and up in preparing a balance sheet to support a dividend.[44]

Where the assets are securities, the plaintiff may rely on market value. He is met with the doctrine that market value represents only "quick" value as opposed to a real, "intrinsic" value, which may be quite different.[45]

Expert testimony is as unreliable here as in most cases.[46] In addition, the plaintiff may have to evaluate good will, at best a slippery subject and one which one court has frankly declined to struggle with.[47]

Perhaps the clearest evidence of the effect of these obstacles is the cases in which the plaintiff won. In the only case arising on the pleadings,[48] plaintiff was relieved of the burden of proof and won. In other cases the corporate books had been discredited by collateral evidence of fraud,[49] or of a disregard of the values shown thereon by the directors themselves.[50] The court was therefore free to find value independently. All other cases involved changes in value so large that the facts themselves carried the burden of proof. In *Branch v. Kaiser*[51] there was a decline of $1,000,000 in the value of assets of a corporation whose capital stock was $1,000,000 and whose purported surplus was only $171,000. No case involved a change in value of less than 100 per cent.[52] Under his present handicaps a plaintiff cannot hope to succeed except in such flagrant cases.

3. *Value and Accounting*

The previous section has demonstrated the difficulty of proving value in the face of corporation accounts. It has therefore been suggested that if a method of accounting were followed which more nearly reflected value, the plaintiff would better be able to establish the first premise of his argument: namely, that a change in value has occurred.[53] The present accounting system is vulnerable on two points. First, it assumes that cost represents value at the time of purchase.[54] This in turn assumes an arm's-length sale. But in actual fact many sales are made in return for shares in the corporation. Since this identifies the seller's interest as a corporate

42. Gallagher v. N. Y. Dock Co., 19 N. Y. S. (2d) 789, 807 (Sup. Ct. 1940). But a tax *assessment* has been accepted as evidence of real value, Randall v. Bailey, 23 N. Y. S. (2d) 173 (Sup. Ct. 1940).

43. Kahle v. Mount Vernon Trust Co., 22 N. Y. S. (2d) 454 (Sup. Ct. 1940).

44. Notes 42 and 43 *supra*.

45. Kahle v. Mount Vernon Trust Co., 22 N. Y. S. (2d) 454, 458 (Sup. Ct. 1940), citing Irving Trust Co. v. Gunder, 152 Misc. 83, 271 N. Y. S. 795 (Sup. Ct. 1934).

46. Compare Kahle v. Mount Vernon Trust Co., 22 N. Y. S. (2d) 454 (Sup. Ct. 1940), where such evidence was belittled, with Whittaker v. Amwell Nat'l Bk. 52 N. J. Eq. 400, 29 Atl. 203 (Ch. 1894), where the court relied heavily on the opinion of experts.

47. Washburn v. National Wallpaper Co., 81 Fed. 17, 21 (C. C. A. 2d, 1897).

48. Seigman v. Elec. Vehicle Co., 140 Fed. 117 (C. C. D. N. J. 1905).

49. Whittaker v. Amwell National Bank, 52 N. J. Eq. 400, 29 Atl. 203 (Ch. 1894).

50. Guaranty Trust Co. v. Grand Rapids Ry., 7 F. Supp. 511 (W. D. Mich. 1931).

51. 291 Pa. 543, 140 Atl. 498 (1928).

52. To the cases cited in notes 49, 50, and 51 *supra*, add Southern California Home Builders v. Young, 45 Cal. App. 751, 188 Pac. 586 (1920). *Cf.* Randall v. Bailey, 23 N. Y. S. (2d) 173 (Sup. Ct. 1940), where an 800 percent increase in value was held available for dividends.

53. Note (1936) 35 MICH. L. REV. 286.

54. Note (1940) 49 YALE L. J. 492, 500.

shareholder with the buyer's interest as corporation, the essential conflict of interests relied on in the assumption that cost gives value disappears.[55]

Secondly, it is assumed that ordinary straight-line depreciation presents the change in value from day to day.[56] Obviously depreciation does not reflect a major change in market value or a sudden technical obsolescence. It is not meant to.[57] The essence of the disparity between accounting value and "real" value is just that the present method of accounting is designed to show cash profit and loss on quick transactions.[58] To do so, the accountant should and does preserve original cost. The trouble is that courts have used these same accounts in applying the balance-sheet surplus test to determine the dividend fund. The court apparently will not recognize its error. The accountant is equally adamant in refusing to reflect unrealized changes in his profit and loss statement. The result is confusion.

A change in value may mean either a change in the general price level, i. e., a change in the value of money, or a change in the value of the property in question in relation to other property.[59] Only the latter produces the situation here discussed, but any proposed accounting method should reflect both. Cost accounting, because it is based on original price in dollars, does not compensate for changes in price level.[60] For instance, if prices decline, a depreciation charge based on original cost will be too large. It will produce a reserve larger than necessary for replacement and will thus divert to that reserve profits which would have been available for dividends.

Two other standards of value are in use for special purposes and have been suggested here. One is the criterion of reproduction cost.[61] If assets were valued at the probable cost of replacement, changes in price level would be reflected. These might then be compensated on the liability side by suitable reserves, thus changing the number of dollars of capital stock to conform with changes in the price level.[62] But this method of valuation still compares property with money, and so does not show changes in relative property value. For instance, a plant made of obsolete material might have a reproduction value of $1,000,000. Yet if an equivalent plant could be built for $500,000, this plant will be worth no more than $500,000 on the open market, or to the corporation as a going concern.[63]

Another suggested standard is that of capitalized expected earnings, which is said to give "going concern" value.[64] The rate of capitalization is one which will attract investors. This means that on sale the plant will bring its capitalized value. Here it seems the comparison with other property devoted to the same purpose is embodied in the rate of capitalization. The comparison between property and money is embodied in the estimate

55. (1941) 50 YALE L. J. 306, 312.

56. Probably no accountant would make such a claim, but the assumption is inherent in many discussions of the subject. Compare KEHL, *op. cit. supra*, n. 12, text p. 92 with cases there cited in n. 25.

57. Note 39 *supra*.

58. Weiner and Bonbright, note 39 *supra*, 335.

59. Note (1936) 35 MICH. L. REV. 286.

60. *Ibid.*

61. *Ibid.*

62. This procedure in various forms has been called an "accounting" or "quasi-" reorganization. See discussion in section 6, page 345 *infra* and generally Katz, *Accounting Problems in Corporate Distributions* (1941) 89 U. OF PA. L. REV. 764, 769; Note (1940) 49 YALE L. J. 492.

63. For an extreme case of similar obsolescence see Guaranty Trust Co. v. Grand Rapids Ry., 7 F. Supp. 511 (W. D. Mich. 1931).

64. 1 DEWING, *op. cit. supra*, note 14, 296-315; Note (1940) 49 YALE L. J. 492, 501.

of future earnings, which should follow prices up or down. Theoretically and in practice this is the best system. There still remains, of course, the problem of adjusting the capital stock to changing price levels.[65] When this has been done, the problem of this note emerges stripped of nonessentials. A criticism against either of these methods of accounting is that they may require a separate accounting for dividend purposes, for it is not likely that the corporation will use such accounting for other purposes.

Valuing current assets is much less difficult. They are rarely held long enough to be affected by major fluctuations in price or value. Generally they are carried on the books at the lower of cost or market,[66] that is, unrealized losses are shown, unrealized gains are not.[67] The inconsistency is apparent. It has been explained as arising from the regulations for income tax returns which allow this method of accounting.[68] Quite possibly the custom preceded and suggested the regulation. Inconsistent though it may be, it has been defended as a "principle of conservatism" which is necessary to offset the natural optimism of the business man.[69]

4. *Nature of Property Involved*

Where the choice between two rules of law and accounting is governed by whether the particular asset is denominated "fixed" or "current," a question arises as to the validity of these classes. One accepted classification draws the line between producer and consumer goods.[70] Another between permanent and fluctuating.[71] Essentially the factual difference involved is a difference in degree of liquidity. Yet this factual difference is probably less important than the difference in function in the corporation.[72] Thus a corporation which bought and sold land, treating it as inventory, was forced to follow the accounting rules for current assets in accounting for it.[73] What is *treated* as current assets becomes current assets.

As liquidity increases, it overshadows the criterion of corporate function.[74] This is probably because the very fact of liquidity makes the corporate function less certain. Thus a security with a ready market may be bought with the genuine intention of treating it as a long-term investment. Yet the fact that to all intents and purposes it represents ready cash constantly tempts the management to sell, either to realize a gain or to prevent a loss. In such a case the intent to treat it as investment or current asset seems insignificant. The element of liquidity is so great that the question may well be whether or not the gain or loss has been realized, especially when securities are distributed as a dividend in kind.[75] Since one basis for applying the "current assets" rule is the expectation of a quick realization,[76] the applicability of that rule to highly liquid assets is clear.

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65. Note 62 *supra.*
66. Weiner and Bonbright, note 11 *supra,* 968 indicates that the rules are much less strictly adhered to in valuing current assets than in valuing fixed assets.
67. *Cf.* Hutchinson v. Curtiss, 45 Misc. 484, 92 N. Y. Supp. 70 (Sup. Ct. 1904) (recovery from directors for dividends paid from unrealized profits on contracts).
68. KEHL, *op. cit. supra* note 12, 109.
69. GRAHAM AND KATZ, *op. cit.* supra note 7, 184.
70. 2 DEWING, *op. cit. supra* note 14, 706-713; Weiner and Bonbright, note 39 *supra,* 339, n. 19.
71. *Ibid.*
72. Emphasized in 2 DEWING, *loc. cit. supra,* note 70.
73. Vogtman v. Merchants' Mortgage and Credit Co., 20 Del. Ch. 364, 178 Atl. 99 (1935).
74. 1 DODD AND BAKER, *op. cit. supra,* note 2, 1107.
75. *Cf.* General Utilities and Operating Co. v. Helvering, 296 U. S. 200 (1935).
76. Weiner and Bonbright, note 11 *supra,* 968.

Other types of assets may be put into one or the other class for reasons more obviously of policy.[77] Good will, for instance, since it represents in practice a part of the purchase price of fixed assets, is often classified with them.[78] Analytically, however, good will is a capitalization of the amount of income in excess of the normal return on equivalent capital. As such it decreases as earnings decrease. It is an unreliable asset at best, and one which conservative management will write down. The rule for current assets tends to write down an asset more than the rule for fixed assets. Therefore, as between the two, policy dictates the choice of the former.[79]

5. *Effect of Statutes*

Since payment of dividends is governed by state statutes, their control over the law is complete in theory, though less important in fact.[80] It is possible, however, that a carefully-drawn statute might solve some or all of the problems raised by this note. In examining existing statutes it is important to note that a majority of corporations are incorporated in comparatively few states.[81] Therefore the pertinent provisions of those states are generally to be considered.

In the first place, the statute should determine the composition of the dividend fund. This may be wholly earnings,[82] wholly corporate surplus,[83] which under a proper accounting system would include unrealized gain, or the familiar combination allowing payment from earnings despite a capital deficit if the latter does not impair the dissolution rights of preferred stock.[84] Which rule, assuming a strict observance by the court, is preferable? Clearly the general scheme of a corporation limits the shareholders to operating profits[85] and requires that gains in fixed assets be distributed, if at all, according to the rules for distribution on dissolution.[86] This suggests the profits test. However, there still arises the problem of a capital impairment from a large unrealized loss. Who should bear this loss?[87] The surplus test throws it on the shareholders; dividends are withheld until the impairment is made good from earnings. The only alternative is to write down assets and reduce capital stock,[88] thereby forcing creditors to bear the loss, in the form of a diminished "cushion" between insolvency and the privilege of paying dividends. This would be the natural effect of the profits test, without revealing it, since evaluation of assets is unnecessary.

Probably in the case of a drastic reduction in value all parties interested in the corporate enterprise, both creditors and shareholders, should

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77. Weiner and Bonbright, note 39 *supra,* 339, n. 19.
78. KEHL, *op. cit. supra,* note 12, 116.
79. Weiner and Bonbright, note 11 *supra,* 959.
80. The only case which treats the problem as one of statutory construction is Randall v. Bailey, 23 N. Y. S. (2d) 173 (Sup. Ct. 1940).
81. The exact percentages are set out in Note (1940) 49 YALE L. J. 492, 496, n. 16. The most important states are Delaware, New York, Pennsylvania, Ohio and New Jersey.
82. Note 9 *supra.*
83. Note 8 *supra.*
84. DEL. REV. CODE (1935) Ch. 65, § 34. Note that this provision does not prevent payment of dividends from a corporate surplus representing unrealized gain in assets.
85. And such a test is recommended in 1 DEWING, *op. cit. supra,* note 14, 684; Weiner and Bonbright, note 11 *supra,* 985.
86. Compare majority and dissenting opinions in People v. Travis, 171 App. Div. 521, 157 N. Y. S. (2d) 943 (3d Dept. 1916).
87. KEHL, *op. cit. supra* note 12, 92 approaches the problem from this standpoint.
88. Note 62 *supra* and discussion in section 6, p. 345 *infra.*

share the loss. The statutes which limit payments from profits while capital is impaired are the first step in such a program. They mark the point at which shareholders must begin to bear the load. The second step would be to correlate statutes governing reduction of capital stock to define how far creditors could be forced to reduce their cushion and accept a permanent share of the loss.

Specific statutory provisions on the smaller issues are rare and apparently ineffective. Pennsylvania, a "surplus" jurisdiction, requires that "losses of every character" be shown.[89] If taken at face value,[90] this indicates a tendency to make shareholders bear the loss. Yet the same statute allows only share dividends from unrealized gain,[91] once more penalizing shareholders for creditors' benefit. There appears to be no theory behind such random provisions. Apparently they were passed helter-skelter to check real or fancied abuses of corporate management.

6. *A Possible Solution: The Holding Company Act*

From the foregoing sections several desiderata emerge. First is the need for an efficient method of enforcing whatever rules govern dividends. Such a method should be preventive rather than remedial in order to avoid the hardship entailed in setting aside an accomplished transaction.[92] It should also be unified, in order to avoid the discrepancies between states and the inevitable rush to incorporate in the most lenient jurisdiction.[93] Section 12 (c) of the Holding Company Act[94] gives the Securities and Exchange Commission in a limited field power to control payment of dividends which nearly satisfies the above requirements.[95] It is unified, preventive, and relatively efficient. It has been suggested that the whole act is an experiment preliminary to a federal incorporation law which would extend this control over a wider field.[96]

Section 12 (c) also satisfies the other need revealed herein, the need for a flexible administration. Because of idiosyncrasies of corporations, the common-law method of rules and remedies is essentially unsuited to their affairs. The wisdom of proposed corporate action may be determined only after study of its condition from the economic, accounting, and legal points of view. The Commission can and does make such a study before allowing any corporate distribution. It is free to choose any system of accounting. It may prohibit dividends from net earnings,[97] or permit dividends while capital is impaired.[98] And it may supervise and control the so-called "accounting reorganization" involved in a simultaneous write-down of capital and assets, thus in effect controlling the distribution of loss.

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89. 15 PA. STAT. ANN. (Purdon, 1938) § 2852-701 (A).

90. Mr. Kehl expects such a holding, KEHL, *op. cit. supra* note 12, 93, but cites to the contrary Solether and Jennings, *Minnesota Business Corporation Act* (1937) 12 WIS. L. REV. 419, 433 to the effect that such a provision will be construed to cover only realized losses.

91. 15 PA. STAT. ANN. (Purdon, 1938) § 2852-701 (A).

92. Note (1940) 49 YALE L. J. 492, 515-16.

93. *Ibid.*

94. 48 STAT. 838 (1935), 15 U. S. C. A. § 79 *l* (c) (1941).

95. The Act provides: "It shall be unlawful for any registered holding company . . . to declare or pay any dividend . . . in contravention of such rules . . . as the Commission deems necessary . . . to protect the financial integrity of companies in holding-company systems, to safeguard the working capital of public-utility companies, to prevent the payment of dividends out of capital or unearned surplus. . . ."

For a more deailed analysis see KEHL, *op. cit. supra*, note 12, 76-81; Note (1940) 49 YALE L. J. 492.

96. Note (1940) 49 YALE L. J. 492, 493, n. 3.

97. Columbia Gas and Elec. Corp., 3 S. E. C. 313, 319 (1938).

98. International Utilities Corporation, 7 S. E. C. 201 (1940).

Decisions under Section 12 (c) are too few to allow more than a rough sketch of results. Apparently the Commission endorses evaluating by capitalization of expected earnings.[99] And the chief accountant has declared specifically that "relatively permanent" losses must be shown.[100]

The method of treating such losses after they are revealed is not definite. The Commission has allowed the cancellation of unrealized losses against unrealized gains,[101] a result which, though theoretically impossible at common law where neither are recognized, had one precedent under state law.[102] The Commission has recognized accounting reorganizations, but has refused to allow subsequent dividend payments where the reorganization was not so "thorough-going" as to be equivalent to the formation of a new company.[103] In the only case yet decided, the so-called "accounting reorganization" was accomplished by writing off against capital surplus an operating deficit which in turn was caused by a retroactive adjustment of a previous entry.[104] Whether the adjustment was necessary because of a loss in value, a previous over-valuation, or a decline in price level is uncertain. Apparently the Commission took the view that it was purely an "earned surplus deficit," resulting from an operating loss, and refused to allow its cancellation against capital surplus.[105] It was a loss that shareholders should bear and could not be shifted to creditors by charging capital. The case has been treated as involving a loss in the worth of fixed assets due to a lowered price level, and criticized as such for not putting that "loss" on the creditors by charging capital.[106] But the facts do not support this view, and dicta in the opinion discussing "accounting reorganizations" clearly indicate that a proper write-down of fixed assets may be charged against capital.[107] There is no evidence to indicate how the Commission will spread a loss which reflects a decline in relative value rather than in the price level.

The importance of the case seems to lie in its demonstration of how the Commission can untangle a complicated factual set-up and arrive at an economically sound result. It is unfettered by procedural rules. The plaintiff is not an impecunious stockholder but the Public Utilities Division. The Commission is free to impose whatever system of accounting best serves its purpose and whatever definition of dividend fund is best for this corporation. In short, it is able to face the problem unhampered by the difficulties of procedure and practice which have rendered a legal solution nearly impossible.

F. L. B., Jr.

Valuation of Restricted Shares for Tax Purposes

INTRODUCTION

Determination of taxable "net income" under the federal income tax may require computation of the "fair market value" of property received.[1] The estate tax, imposed upon the transfer of the net estate of every de-

99. Note (1940) 49 YALE L. J. 492, 510, n. 67.
100. Quoted in Note (1940) 49 YALE L. J. 1319, 1322.
101. Philadelphia Co., 6 S. E. C. 752 (1940).
102. Titus v. Piggly Wiggly Corp., 2 Tenn. App. 184 (1925).
103. Associated Gas and Elec. Corp., 6 S. E. C. 605, 620 (1940).
104. *Id.* at 614.
105. *Id.* at 619.
106. KEHL, *op cit. supra*, note 12, 98, n. 39.
107. *See* Associated Gas and Elec. Corp., 6 S. E. C. 605, 622 (1940).

1. INT. REV. CODE § 111 (b) (1939).

cedent,[2] by administrative interpretation similarly involves determination of the "fair market value" of every item of property includable in the gross estate at the time of decedent's death.[3] In the same way, the gift tax imposed upon the transfer of property by gift has been interpreted to require determination of "fair market value" of each unit of property.[4] The measure of value to be employed is stated in other words in other statutes,[5] but the courts have almost invariably held that the legislative meaning is "fair market value." [6]

Fair market value of corporate shares may be affected by contractual restrictions upon power to transfer.[7] The incumbrance may take the form of an option in the corporation to repurchase the shares at a figure less than market value at a determinable future time,[8] or at the time of some attempted disposition by the holder.[9] It may take the form of a restriction on the number of possible purchasers.[10] Or it may involve an absolute restriction on disposition for a limited period.[11]

It has been suggested by some courts that such restrictive contracts, although valid for other purposes between the contracting parties, do not affect determination of the tax value of the share interest unless contained in the corporate charter or by-laws, or set out on the face of the share certificate.[12] Such a formalistic conception of the corporate share can hardly be supported. When a taxpayer receives or transfers in a taxable transaction a corporate share subject to burden on rights of alienability,

2. INT. REV. CODE § 810 (1939).

3. U. S. Treas. Reg. 80, Art. 10.

4. U. S. Treas. Reg. 79, Art. 19(1).

5. "True and full value in money," "full and true value immediately," "value," "clear market value on death," "market value," "fair market value," "net market value" are variously used, 4 C. C. H. 1941 State Inheritance, Estate, and Gift Tax Serv. ¶ 1800A.

6. PAUL, STUDIES IN FEDERAL TAXATION (1937) 171. Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell." U. S. Treas. Reg. 80, Art. 10; U. S. Treas. Reg. 79, Art. 19(1). PAUL, STUDIES IN FEDERAL TAXATION (1937) 171.

7. General discussion of the problem may be found in 2 BONBRIGHT, VALUATION OF PROPERTY (1st ed., 1937) 1040 *et seq.* (income tax); HUGHES, FEDERAL DEATH TAX (1938) § 169; PAUL, STUDIES IN FEDERAL TAXATION (1937) 212 *et seq.;* PAUL AND MERTENS, FEDERAL INCOME TAXATION (1934) § 52.22; Note (1936) 102 A. L. R. 6, 21.

8. See cases cited notes 21 and 22 *infra.*

9. The form is ordinarily a requirement that shareholder offer to the corporation for a period of days or months before attempting to sell or otherwise transfer. See cases cited notes 28, 29, and 31 *infra.*

10. See cases cited notes 40 and 43 *infra.*

11. See cases cited notes 52 to 56 *infra.*

12. In Bryant v. Commissioner of Corporations and Taxation, 291 Mass. 498, 501, 197 N. E. 509, 511 (1935), the argument is set forth in some detail. "The limitation . . . was not inherent in the stock itself. . . . It was extraneous to the stock although accompanying its acquisition by the taxpayer. . . . The full and complete ownership . . . vested in the taxpayer at the time of the exchange. . . . tax laws cannot be frustrated or rendered difficult of enforcement by contracts lying outside the essential features of a sale of stock." There is a good deal of language to this general effect in the decisions of the Board and in Federal cases. *See* G. & K. Mfg. Co. v. Commissioner, 76 F. (2d) 454, 456 (1935); Newman v. Commissioner 41 F. (2d) 743, 744 (1930); T. W. Henritze, 28 B. T. A. 1173, 1176 (1933); City Bank Farmers Trust Co., 23 B. T. A. 663 (1931). See (1935) U. OF PA. L. REV. 1028, 1030 suggesting that all restrictions be ignored for tax purposes.

There is substantial disagreement as to when a restriction may be said to be "inherent." *See* T. W. Henritze, 28 B. T. A. 1173, 1176 (1933) (restrictions stamped on share certificate not inherent); *see* Attorney-General v. Jameson [1904] 2 Ir. Rep. 565, 690, 691 (restriction in articles not inherent. Dissenting opinion).

he receives or transfers but a part of a divided property interest,[13] and should not fairly be asked to pay a tax measured on the whole interest.[14] If the restriction is in fact unenforceable, or intended not to be exercised, and the fact is proved, then the divided interest only apparently exists; and the whole share value should be taxable.[15] However, it is possible that even an unenforceable restriction might have an apparent validity such as to reduce the value of the right to sell the shares in the same manner as a cloud on title of real estate.

Option to Purchase at Less Than Market Value

Control over the persons who shall own shares of a corporation is often exercised by existing shareholders by means of a reserved option right to repurchase the share at market value[16] or less in the event that a holder desires to dispose of his shares.[17] The device is not unusual in small corporations where it is desired that ownership be limited to the families or associates of existing shareholders. It is also employed in shares issued to employees in order to ensure their loyalty to the issuing corporation, such restriction providing, in addition to restriction on sale, for reservation of option in the corporation which may be exercised when the employee leaves the corporate employ.[18]

If, at the time it passes on exchange, gift, or death, and becomes subject to the tax, the share is subject to an immediate option in corporation to purchase at less than value, the taxable value of the interest which passes is determined by the price at which the recipient must sell it under the option.[19] The contingent option becomes separated from the share at

13. "Compared with the absolute right to go into the open market and sell . . . property that was subject to no restrictions on alienation—present or future—this interest was what I may venture to call a dwarfed and stunted thing." Kenny, J., in Attorney-General v. Jameson [1904] 2 Ir. Rep. 644, 673.

14. "Such an argument [as that in dicta cited in note 12] can proceed only on the theory that it is the duty of the Courts to so construe the Revenue Law as to make it prolific of revenue. . . ." Hughes, Federal Death Tax (1938) § 169, p. 302. The argument has apparently gone by the boards in both England, see cases cited note 29 *infra*, and the United States.

15. As to validity and enforceability of restrictions on corporate shares in general see cases and materials cited in Frey, Cases and Statutes on Business Associations (1935) 376. No case has apparently yet involved assertion of invalidity, by taxpayer, of a restriction in a share transferred to him. Taxpayer ordinarily asserts validity.

16. Of course mere option to purchase at highest offered market price would not appreciably affect market value despite possible inconvenience. *Cf.* Jay N. Darling, 4 B. T. A. 499 (1926). Query what result in the situation where optionee is to determine "fair market value" himself?

17. The option may inhibit only power of sale; or it may hamper power to give or devise as well.

18. See *e. g.*, Charles T. Kline, 44 B. T. A. No. 161, July 19, 1941.

19. Commissioner v. Bensel, 100 F. (2d) 639 (C. C. A. 3d, 1938), *aff'g*, Edith M. Bensel, 36 B. T. A. 246 (1937); Wilson v. Bowers, 57 F. (2d) 682 (C. C. A. 2d, 1932), *aff'g*, Wilson v. Bowers, 51 F. (2d) 261 (S. D. N. Y., 1931); John Mitchell, 37 B. T. A. 1 (1938). The possibility that the option will not be exercised is not relevant if the enforceable power to obtain the shares for less than their market price is outstanding in the hands of optionee. A valuable part of the share interest is in the hands of optionee and on this he can be taxed. Moran v. Lucas, 36 F. (2d) 546 (App. D. C. 1929). The dictum in *Wilson v. Bowers*, that evidence that option was in fact not exercised was barred by the rule against evidence of subsequent happenings, would not be necessary under this view. Query the result in a situation where it is clear at time as of which tax is computed, that option will not be exercised, although the legal right remains in optionee. *Cf.* Charles T. Kline, 44 B. T. A. No. 161, p. 5, July 19, 1941 (evidence that option not intended to be asserted).

the time of the option contract, remains throughout in the hands of optionee, and so does not pass on death, gift, or exchange.[20]

If the option right is not then immediately exercisable, the value of the shareholder's interest will probably be larger than option price. If the option is to be exercised at a determined future time, the value to the shareholder would probably be accurately represented by a figure composed of the sum of present value of any prospective earnings of the share in the interval, plus present value of the expectation of receiving option price on the determined date.[21] If the option is one which may be exercised upon death of shareholder, the expectable yield of the share in the interval may be roughly computed by an estimate of the life expectancy of the shareholder at the moment of the gift or exchange.[22] Determination of the period during which the shareholder may expect to receive the beneficial incidents of ownership may be yet more speculative, as when the option is to become immediate upon his leaving the corporate employ.[23]

An option may be one which attaches only upon attempted disposition of the share by the holder. The value of the share interest to the holder under such a restriction should vary inversely with that portion of the value of the whole share which would be represented by the absent powers of disposal. Power of disposition by gift or will would perhaps always be incidents of some value. Power of sale in the open market might be a large or small incident of value as to the particular security.[24] The investor in shares of a sound, strategically well situated corporation with high earnings and satisfactory dividend policies might well ignore the power of sale on the open market as a value factor.[25]

If a substantial portion of the value of the ordinary security is represented by saleability on the market, the value of the shareholder's remaining interest would best be computed by looking at all relevant factors, such as earnings, stability, control, strategic position, pre-emptive rights, option price, dividend policy, and perhaps managerial skill, and arriving at an estimate of what it would be worth to a hypothetical buyer to be placed in the shoes of the holder as to that stock.[26]

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20. *Contra:* Palles, C. B., dissenting, in Attorney General of Ireland v. Jameson [1904] 2 Ir. Rep. 644, 682 *et seq.*

21. However, in *Helvering v. Salvage,* 297 U. S. 106 (1936) option price was held determinative in the following circumstances. Corporation transferred to taxpayer in 1922, shares of "intrinsic value" $1,164.70 for $100 each, in return for a covenant not to compete and an option to repurchase the shares at $100, 5/7 in 1923, 4/7 in 1924, etc. Taxpayer asserted a basis of $1,164.70 per share on a subsequent transfer of the shares. The Commissioner successfully contended that price for which taxpayer might be obliged to resell in 1923 fixed the value of the shares received by taxpayer. It was not argued that possible earnings of shares in the one year interval might have some effect. Query whether the same result would have been reached had it been shown that earnings were to be expected in the period taxpayer had a right to retain the shares. In *Charles T. Kline,* 44 B. T. A. No. 161, July 19, 1941, the option was to be exercised on death of donor. Value of gift of share was computed to be *greater than* option price, and taxpayer's contention that option price should govern was rejected.

22. *Ibid.*

23. *Ibid.* When "entire record affirmatively indicates the probability of his continued employment" possibility of exercise of the option is discounted.

24. "Power of unrestricted alienation is a usual concomitant of ownership of property. When such power is separated from the ownership the value of the property, certainly as a trading commodity, is usually lessened. . . ." Frederick A. Koch, 28 B. T. A. 363, 365 (1933).

25. "Power of alienation, or its absence, would not affect the value of property in the hands of one who wished not to sell." *Id.,* at 366. In the *Koch* case taxpayer asserted that option price determined tax value. The corporation had been formed to construct a particular building, and it did not appear that shares were intended to be sold.

26. See generally, Phillips v. U. S., 12 F. (2d) 598, 603 (W. D. Pa., 1926); Attorney General v. Jameson [1905] 2 Ir. Rep. 218, at 227; HUGHES, FEDERAL DEATH

Option price would equal value of the restricted shares only in case power of disposition were the sole valuable incident of share ownership.[27] Where a higher valuation is set with regard to value factors, it will be supported by the Board.[28] The same rule obtains as to tax statutes of other jurisdictions.[29]

In *Lomb v. Sugden,*[30] however, the Circuit Court for the Second Circuit reversed a district court which had upheld a finding of the Commissioner based on consideration of the value factors above mentioned,[31] and held the option price determinative. The view seems questionable.[32] A similar view, but one more plausible under the words of the English statute,[33] was rejected by the House of Lords in *Inland Revenue Commissioners v. Crossman.*[34] The English estate tax provides for valuation of the estate according to "the price" the commissioners think the property will fetch in the open market.[35] The language of the statute induced the majority of the King's Bench to hold that tax value could be no greater than the price at which the property could be sold, i. e., option price, despite the fact that earnings of the shares were extremely high.[36] The House of Lords resolved the problem by reiterating the rule of *Attorney General of Ireland v. Jameson,*[37] that market "price" under the statute means *value* of shareholder's interest,[38] and upheld a determination of tax value based upon consideration of all relevant factors.[39]

TAX (1938) § 162, at 275 *et seq.* The customary method for valuing close stock is employed, with the added consideration of the absence of alienation rights as a depressant factor.

27. If the circumstances of the holder were to make it necessary that he sell the property at the time the valuation is made, query whether the concept of "value to the owner" would be employed? What of an executor if the property has to be divided?

28. Frederick A. Koch, 28 B. T. A. 363 (1933); Michigan Trust Co., 27 B. T. A. 556 (1933); City Bank Farmers Trust Co., 23 B. T. A. 663 (1931); Louis N. Schulz, 14 B. T. A. 419 (1928). The *Michigan Trust* case distinguishes *Wilson v. Bowers* on the immediacy point. The distinction is seldom clearly made in the opinions. The results are in part fostered by the presumption of commissioner's correctness.

29. Commissioner of Corporations and Taxation v. Worcester County Trust Co., 305 Mass. 460, 26 N. E. (2d) 305 (1940) in which the point is clearly made. Inland Revenue Commissioners v. Crossman *et al* [1937] A. C. 26; Salvesen's Trustees v. Commissioner of Internal Revenue [1930] 1 Scots. L. T. 387; Attorney General of Ireland v. Jameson [1905] 2 Ir. Rep. 218.

30. 82 F. (2d) 166 (C. C. A. 2d, 1936).

31. Lomb v. Sugden, 11 F. Supp. 472 (W. D. N. Y. 1935).

32. Implicit in the holding is perhaps a realization of the convenience of the option price as an index. Query the reaction of the second circuit to a case should yearly earnings be 20% or higher, as in the Irish and English cases cited note 29 *supra.* In Helmholz, 28 B. T. A. 165, 175 (1933) the Board held, where a poor dividend record was shown, and the state appraiser had valued at 100 (option price), that commissioner's determination of value at 320 could not be supported but that 100 was the proper value. In the circumstances it is probable that the value of the shares *was* in fact no greater than option price.

33. Finance Act, 57 and 58 Vict. c. 30, § 1, § 7 (1894).

34. [1937] A. C. 26.

35. "The principal value of any property shall be estimated to be the price which, in the opinion of the Commissioners, such property would fetch if sold in the open market at the time of the death of the deceased." Finance Act, 57 and 58 Vict. c. 30 § 7 (5).

36. *In re* Paulin, *In re* Crossman [1935] 1 K. B. 26, (1935) 83 U. OF PA. L. REV. 1028.

37. [1905] 2 Ir. Rep. 218.

38. The estimated price which a hypothetical buyer would pay to be placed in the shoes of the shareholder.

39. The Commissioner had claimed that the restriction should have no effect. The taxpayer had asserted that option price should limit tax value. The court properly held both views extreme.

RESTRICTIONS ON TRANSFER TO ONE OUTSIDE A DETERMINED OR DETERMINABLE GROUP

Restrictions on power of alienation may take the form of prohibition of transfer outside of a certain group,[40] or of absolute restriction on transfer without consent of the members of the group.[41] Such restrictions sometimes replace the option as a means by which control of the persons who shall obtain corporate membership may be exercised by existing shareholders.[42] They may, applied to voting shares, be employed as devices to preserve control of a corporation in the majority group.[43]

Under these circumstances, again, if the incident of transferability of the share is a negligible incident, its presence or absence might not affect tax value. If power of alienation is a valuable portion of the share interest, the extent to which it is impaired by the particular restriction is important.[44]

That all the shareholders in the group agree that shares shall not be sold without consent of the group, ordinarily indicates, in the absence of adverse interests among the various members, that the restriction will not be enforced if it becomes a burden decreasing the value of the shares.[45] Taxpayer may of course show that the fact is otherwise, if he can sustain the burden of proof. As a general proposition it may nevertheless be said that this type of restriction is unlikely to be asserted successfully as a factor reducing tax value.[46]

The price at which the property may be disposed of in a market limited to a particular group may be no lower, or may be in particular cases even higher, than the price at which it could be sold in the open market.[47]

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40. Estate of Nieman, 230 Wis. 23, 28, N. W. 452 (1939) (group limited to those who would carry on ideals of the business); R. E. Baker, 37 B. T. A. 1135, 1155 (1938) (employees).

41. See cases cited note 43 *infra*.

42. Estate of Nieman, 230 Wis. 23, 283 N. W. 452 (1939); R. E. Baker, 37 B. T. A. 1135, 1155 (1938); Henry K. Chapin, 33 B. T. A. 688 (1935).

43. Newman v. Commissioner, 40 F. (2d) 225, *aff'd on rehearing*, 41 F. (2d) 743 (C. C. A. 10th, 1930); Rodrigues v. Edwards, 40 F. (2d) 408 (C. C. A. 2d, 1930) (employee shares); Heiner v. Crosby, 24 F. (2d) 191 (C. C. A. 3d, 1928); Phillips v. U. S., 12 F. (2d) 598 (W. D. Pa. 1926), *aff'd*, Phillips v. U. S., 24 F. (2d) 195 (C. C. A. 3d, 1928).

44. Requirement of third party consent of course does not bar negotiation. It may reduce value dependent on the circumstances, but the burden of proof is on taxpayer who asserts the lowered value. Rodrigues v. Edwards, 40 F. (2d) 408 (C. C. A. 2d, 1930), *aff'g*, 33 F. (2d) 1003 (1929) (taxpayer argued only that restriction destroyed tax value, and so, of course, lost).

45. Newman v. Commissioner, 40 F. (2d) 225 (C. C. A. 10th, 1930), *aff'd on rehearing*, Newman v. Commissioner, 41 F. (2d) 743 (C. C. A. 10th, 1930); Henry K. Chapin, 33 B. T. A. 688 (1935).

46. In the *Nieman* case, note 40 *supra*, the facts were that shares controlling a newspaper were left to executor with directions that they be sold only to one who would carry out decedent's ideals. Apparently no inquiry was made among the hypothetical group which would qualify before selling to A, who qualified. Offers at considerably higher figures than that paid by A were available from B, C, and Mr. Annenberg. Offers of these parties were considered in computing fair market value. The court indicated in dictum that it would have reached the same result even had A been the bona fide highest bidder of the qualified group. If so, this is a rather harsh view. Compare note 27 *supra*.

47. In *Henry K. Chapin*, 33 B. T. A. 688 (1935) a corporation formed to construct a cooperative apartment house in an exclusive section of Chicago and market apartments therein, was attempting to set up a restriction on transfer of shares to persons unapproved as prospective tenants by the corporate members. The Board properly held that the restriction created no burden on marketability, since the restrictions, though limiting prospective buyers to a smaller group than otherwise would have been the case, so limited the market only for the reason that the restricted market was active and could be expected to offer a much higher return on the shares than could be ob-

Further, although it be impossible to market successfully the share in the restricted group, the presence of the restriction may result in added value to the shareholder which more than compensates for the absence of the usual power to dispose of his interest. Thus, where the restriction is intended to maintain voting control of a corporation in the majority group of shareholders, the value of the share so restricted may be computed to be a fraction of the value of the controlling interest, plus its other incidents of value; and, as such, to have a higher tax value than unrestricted shares.[48]

ABSOLUTE RESTRICTIONS FOR LIMITED PERIODS

In exchange for a transfer of shares or assets to a corporation, the taxpayer may receive shares of the corporation subject to an absolute restriction on sale or alienation for a period of months or years. The balance of shares of the issuing corporation remain on the market unrestricted during the restrictive period. Sales of unrestricted shares may well be an approximate index of fair market value of those received by taxpayer if it appears from the surrounding circumstances that (a) the marketing of unrestricted shares is not being artificially supported, and (b) that the temporary absence of rights of alienation is not a sufficiently important factor to reduce value of restricted shares below that of the unrestricted shares in any event. Accordingly, shares received in such an exchange by a taxpayer, who agreed to participate in a projected sale of the assets of the issuing corporation to another organization and to hold his shares for ninety days while the deal was being negotiated, were held in *G. & K. Mfg. Co. v. Comm'r* [49] to be properly valued for income tax at the market price of unrestricted shares. The court stated that the surrounding circumstances [50] were sufficient to remove a usual presumption that presence of a restriction lowers the fair market value of shares subject thereto.

Language may be found in this, as in other decisions and rulings, to the effect that a restriction "voluntarily entered into" by the taxpayer cannot destroy or reduce the tax value of his shares.[51] It hardly seems that the voluntary nature of such a contract should affect the fact if the share-

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tained by unrestricted sales. The Board took into account that the restrictions would unquestionably be removed upon any substantial drying up of the exclusive market, and buttressed its conclusion by evidence that subsequently such was the case.

48. In *Phillips v. U. S.*, 12 F. (2d) 598 (W. D. Pa., 1926), *aff'd*, Phillips v. U. S., 24 F. (2d) 195 (C. C. A. 3d, 1928); and *Heiner v. Crosby*, 24 F. (2d) 191 (C. C. A. 3d, 1928) 51% of the shares of Pure Oil had entered into a covenant not to sell for 20 years. A few of the remaining shares were sold in the market, and the Treasury attempted to establish market value of such shares as determinative of the value of the restricted share. The taxpayer successfully asserted a higher value in establishing a 1913 basis for the shares. (See language on p. 603 of the *Phillips* case in the District Court). In *Newman v. Comm'r*, 40 F. (2d) 225 (C. C. A. 10th, 1930) the Commissioner valued a share at its worth as a part of the controlling interest of the corporation which could have been sold for $2.00 a share. The fact that controlling shareholders would neither consent to sell, nor permit sale of taxpayer's shares alone was held not to rebut the Commissioner's valuation.

49. 76 F. (2d) 454 (C. C. A. 4th, 1935).

50. Shares were transferred to taxpayer corporation to be held for ninety days, until a projected merger of issuing corporation, which was to be advantageous to all shareholders, restricted or not. The price of unrestricted shares rose steadily until the merger was successfully consummated. Power to sell the share during the ninety days could hardly have been very important in the circumstances.

51. ". . . a voluntary agreement to abstain from the sale or transfer of property received in a sale or exchange need not be considered in determining the market value of the property received." G. & K. Mfg. Co., 76 F. (2d) 454, 457 (C. C. A. 4th, 1935). See note 12 *supra*.

holder does receive something of less value than an unrestricted share because he has contracted with an adversely interested party not to receive a property right ordinarily incident to ownership of the share. The typical situation involves the launching of a new enterprise, wherein shares of the new corporation go part to syndicate bankers to be sold to the public; and part to shareholders of the old corporation, subject to a restriction on transfer coextensive with projected syndicate operations. The price of unrestricted shares does not ordinarily reflect in fact the value of the restricted share to its holder. If the intrinsic worth of the corporation does not justify the market price of the unrestricted shares, it is probable that the restricted shares on the termination of syndicate operations will not be saleable at that figure.

Where, in such a situation, the Board is able to determine from the dealings of the parties to the transaction what value was placed by them upon the shares so restricted, that figure is adopted.[52] In a situation, for example, where in the general fact situation above outlined, the taxpayer is given the choice of receiving, instead of one-half the number of shares of the new corporation contracted for, a stated amount of cash, and in fact takes both shares and cash, the value so computed in contemplation of the restriction on the shares by the parties most familiar with the circumstances may be taken as determinative.[53] Such dealings to be of value must, of course, be as to shares to be restricted. Price paid by the syndicate for unrestricted shares should not be persuasive.[54]

Ordinarily such apparent method of valuation is unavailable. If the fact is so, and the Commissioner finds fair market value equal to the market price of unrestricted shares, that valuation may stand on the strength of the presumption of correctness of the Commissioner's findings [55] unless the taxpayer makes available to the Board evidence of the intrinsic value of the Corporation's assets and so permits the establishment of a lower valuation.[56]

The principle that evidence of subsequent events should not be taken into account in determining fair market value as of the date of the transaction is sometimes of importance in this connection. Prices of shares after completion of the syndicate operations may or may not be admissible, dependent on the circumstances. A decline in prices after the restriction terminates may tend to show that the price of unrestricted shares during the syndicate operations is no true index of their intrinsic value at that time and *a fortiori* no indication of the tax value of restricted shares not possessing advantages of saleability in the inflated market.[57] The decline may, on the other hand, do no more than reflect a general fall of market

52. Bassick *et al.* v. Comm'r, 85 F. (2d) 8 (C. C. A. 2d, 1936), *aff'g,* Wilbur F. Burns, 30 B. T. A. 163 (1934); Henry S. Parker, 11 B. T. A. 1336 (1928).

53. *Ibid.*

54. E. F. Simms, 28 B. T. A. 988, 1018 (1933).

55. G. & K. Mfg. Co. v. Commissioner, 76 F. (2d) 454 (C. C. A. 4th, 1935); Fesler v. Commissioner, 38 F. (2d) 155 (C. C. A. 7th, 1930); Western Industries Co., 30 B. T. A. 809 (1933); T. W. Henritze, 28 B. T. A. 1173 (1933); *see* Minnesota Tea Co., 28 B. T. A. 591, 596 (1933).

56. E. F. Simms, 28 B. T. A. 988, 1016, 1018 (1933); Wallis Tractor Co., 3 B. T. A. 981 (1925); *see* Western Industries Co., 30 B. T. A. 809, 813 (1933).

57. In every case found involving sale of unrestricted shares while shares sought to be taxed were subject to restriction, the price of shares after termination of the syndicate operations and concurrent restrictive period was considered. Tex-Penn Oil Co. v. Commissioner, 83 F. (2d) 518 (C. C. A. 3d, 1937), is a square holding to the effect that such evidence is proper in order to show speculative nature of the enterprise whose shares are being sold at prices unjustified by corporate prospects.

prices at the time, which latter fact should have no effect on determination of value as of the date of the transaction.[58]

The taxpayer's evidence of fair market value lower than that established by the Commissioner must, it seems, consist of something more than testimony of expert witnesses to the effect that the value of taxpayer's interests could not have been sold for more than a nominal price at the time of the transaction without delivery of possession of the share. The standard of market value seems to give way to that of value to the owner in such case. The question of the value of the interest held by taxpayer is not precluded by the fact that it is temporarily unsaleable.[59] The taxpayer may not safely rely on book value, but should apparently be prepared to show exhaustively the intrinsic value of the corporation's assets.[60] They are valued by the Board by no specific set of rules, but on the basis of their experience in weighting the various factors involved in similar cases.[61]

THE TEX-PENN SITUATION

Although the presence of contractual prohibitions of, or limitations on, transfer had prior to 1938 been uniformly held not to have the effect of removing "fair market value" from a corporate share,[62] there were decisions to the effect that the nature of a corporation might be so speculative that its shares even in the absence of restrictions would have no fair market value. It was held that no taxable gain arose for this reason in transactions involving shares of a corporation whose assets consisted of oil land the title to which was subject to litigation of adverse claims which, if successful, would not only have eliminated its assets but have subjected it to serious liability as well,[63] in transactions involving shares of highly speculative stock based on oil leases which could only be sold at a sacrifice,[64] and in transactions involving shares supported by heavily encumbered realty.[65]

With the general background as stated, the question was raised in *Tex-Penn Oil Co. v. Comm'r*[66] whether restricted shares of a corporation, whose future was highly speculative because of the nature of its assets, might be held to have no fair market value even though a ready market existed for the unrestricted portion of the shares. Taxpayer's assets consisted of "wildcat" oil leases. Oil had been discovered on the land, and a capitalization project thereafter carried out, by the terms of which the

58. However, drop in market prices coincident with the 1929 market collapse was considered in cases cited, notes 67 to 70 *infra*.

59. The argument that removal of power to sell a regular interest in an orderly market does away with fair market value was made in almost every case, and consistently rebuffed. Fesler v. Commissioner, 38 F. (2d) 155 (C. C. A. 7th, 1930); T. W. Henritze, 28 B. T. A. 1173 (1933); Western Industries Co., 30 B. T. A. 809 (1933). Query whether the Tex-Penn decision has now made the argument respectable.

60. Book value is one of the most unreliable indices of value, yet taxpayers based their valuations thereon in Western Industries Co., 30 B. T. A. 809 (1933); T. W. Henritze, 28 B. T. A. 1173 (1933). In *Western Industries Co.* shares of book value $4.05 had earned $1.85 in the nine months previous to the valuation.

61. E. F. Simms, 28 B. T. A. 988 (1933); Wallis Tractor Co., 3 B. T. A. 981 (1925). *Contra:* Tex-Penn Oil Co. v. Commissioner, 83 F. (2d) 518 (C. C. A. 3d 1937).

62. See note 59 *supra*.

63. Champlin v. Commissioner, 71 F. (2d) 23 (C. C. A. 10th, 1934).

64. O'Meara v. Commissioner, 34 F. (2d) 390, 395 (C. C. A. 10th, 1929).

65. Mount v. Commissioner, 48 F. (2d) 550 (C. C. A. 2d, 1931) *rev'g* 16 B. T. A. 847 (1929). These cases were decided with emphasis on wording of statute "fair market value, *if any*." Query whether same result follows now.

66. 300 U. S. 481, *aff'g*, Tex-Penn Oil Co. v. Commissioner, 83 F. (2d) 518 (C. C. A. 3d, 1939), which reversed 28 B. T. A. 917 (1933).

oil leases were conveyed to a new corporation, part of whose shares were received in exchange subject to six months restriction on transfer if syndicate operations contemplating sale of unrestricted shares should continue so long. The Board of Tax Appeals after study of the intrinsic assets of the new corporation in order to determine fair market value of its shares, and on "studied consideration of all pertinent facts and applicable factors", reached a valuation for the property at the date of the exchange. The Circuit Court, expressly considering the fact that the enterprise "blew up" before the end of the restrictive period, determined that the shares had no fair market value. On appeal, the Supreme Court stated that "the judgments must be affirmed upon the ground that in the peculiar circumstances of this case, the shares of Transcontinental stock, regard being had to their high speculative quality and to the terms of a restrictive agreement making a sale thereof impossible, did not have a fair market value, capable of being ascertained with reasonable certainty, when they were so acquired by the taxpayers. In the absence of such value, the ownership of the shares did not lay the basis for computation of a gain at the time they were received, or for a tax as to that date under the applicable statute."

Four considerations are mentioned in the opinion: (1) peculiar factors of the case, (2) highly speculative quality of the shares, (3) terms of the restrictive agreement, and (4) the applicable statute. Later cases have revealed considerable uncertainty as to what similar combinations of fact should impel a like conclusion.

The absolute restriction for a limited period of time, it must be remembered, is typical of the period of launching of a corporate enterprise. Every new corporation involves some element of speculation. A loose interpretation of the Tex-Penn rule might conceivably remove almost every transaction of this type from income tax liability. How much element of speculation is necessary to bring a given situation within the rule may cause some difficulty.

In the *Tex-Penn* case the nature of the corporate assets was responsible for the speculative nature of its shares. In *State Street Trust Company*,[67] a corporate unit of an unstable holding company pyramid, whose shares were subject to violent fluctuations, was held to be within the rule. In *Morris D. Kopple*,[68] dissension among the shareholders was the only point indicating speculative nature. In *Schuh Trading Company*,[69] the new corporation was a holding company engaged in buying up some sixty wholesale drug companies. The court stated that since the corporation was a new enterprise, without officers experienced as to operations on such a vast scale, "with a future wholly unknown," and stock "as yet unseasoned," it fell within the scope of the *Tex-Penn* case.[70] In fact, however, the reasoning of the court does *not* align with the *Tex-Penn* case, for the court did find a value for the shares, equal to market price after the conclusion of the syndicate operations.

In *Gwinner v. Heiner*,[71] the court held that where the occasion of the restriction is an issue of securities of an established and sound corpora-

67. 37 F. Supp. 846 (D. Mass. 1941).

68. 34 B. T. A. 1056 (1937).

69. 95 F. (2d) 404 (C. C. A. 7th, 1938).

70. *See* Morris D. Kopple, 34 B. T. A. 1056, 1063 (1937).

71. 114 F. (2d) 723 (C. C. A. 3d, 1940), *rev'g* Gwinner v. Heiner, 25 F. Supp. 659 (W. D. Pa. 1938). The district court had stated that "to fix a fair market value on this stock . . .during the term of the restrictive agreement *would be unfair to the government* in the determining of the gain or loss from the transaction because the price of such stock would necessarily not be its fair market value." [Italics added.]

tion, there should be no question but that fair market value exists if the restriction is not of too long duration.

The Tex-Penn decision settled that presence of a restrictive agreement may, in conjunction with some speculative character of the security which appears likely to prevent ultimate realization of gain, prevent valuation as of the date securities are received for income tax purposes. In *Propper v. Commissioner*,[72] a further step was taken when a prohibition of sale of shares of an apparently sound corporation for five years was held determinative of the fact that the shares had no fair market value. This case stands alone in placing sole emphasis on the restrictive agreement. It is, however, worthy of note that in the *Tex-Penn* case the restriction was at most six months in duration, and in the cases following, although none involved restrictions of less than six months, the longest was one year.

It is questionable whether valuation will be prevented in the case of anything less than absolute prohibition of rights of disposition of the share.[73] If the form of restriction is, for example, prohibition of sale outside a group, prices obtainable within the group might determine if higher than "sacrifice" prices.[74] Where consent of another to *any* disposition is necessary it becomes important, in the case of a speculative share, how easily the consent can be obtained. As a procedural matter the onus is apparently on the taxpayer to show futile attempts to obtain consent.[75]

Tex-Penn purports to deal only with "the applicable statute." It may be surmised that the rule, if it is carried over to estate or gift taxes at all, will not be there extended.[76] For as to the income tax there is a strong possibility that if property is not taxed as income at the time of the transaction, collection of the tax may be but postponed to a later date.[77] As to estate and gift taxes, if value is found absent at the date the transaction occurs, the property wholly escapes taxation.

Conclusion

If a contract is made by a shareholder to refrain from exercising some of the rights of transferability ordinarily incident to ownership of a corporate share, and the contract is enforceable and intended to be enforced when made, the value of that share for tax purposes is probably lessened. The extent to which this is so depends upon how much of the normal power of unrestricted alienation is removed by the particular restriction, and how valuable the absent powers are as to the particular share under the circumstances of the case. The value of a share crippled by the

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72. 89 F. (2d) 617 (C. C. A. 2d, 1937).

73. R. E. Baker, 37 B. T. A. 1135, 1155 (1938). Taxpayer claimed that cost basis could not be allocated between A & B shares because sale of B shares was restricted to employees. There were sales of shares among the 41 employees. In concluding shares had a market value the court distinguished the *Tex-Penn, Propper,* and *Kopple* cases on the fact that each involved *absolute* restriction.

74. *Ibid.*

75. State Street Trust Co. v. Commissioner, 37 F. Supp. 846 (D. Mass. 1941). The court here was convinced that no consent could have been obtained. Compare Bryant v. Commissioner of Corporations and Taxation, 291 Mass. 498, 197 N. E. 509 (1935) in which no such showing was made, and taxpayer lost, although the transaction was identical in both cases.

76. In the *Kline* case involving the gift tax, *Tex-Penn* was distinguished on other grounds. Charles T. Kline, 44 B. T. A., No. 161, July 19, 1941. In *John Mitchell* which dealt with immediate option to purchase under the estate tax the case was not cited, John Mitchell, 37 B. T. A., (1938).

77. *See* Hughes, Federal Death Tax (1938) § 147.

absence of alienation rights must be determined by a selective weighing of all the factors bearing on the value the particular share would represent to a potential buyer. In the case of an immediate option to purchase, or in a case where dealings by the parties as to the share as restricted may afford a clue to its value, an accurate short cut method of evaluation may be available. Option prices, or the sale price of ordinary securities of the same issue do not otherwise ordinarily furnish a reliable basis for evaluating worth of the share. Since such figures will then only fortuitously reflect the actual value of the interest to be valued, convenience alone should not induce their adoption.

The difficulties of reaching a workable basis for evaluation of absolutely restricted shares received on an exchange of property have induced the Supreme Court in the *Tex-Penn* case to abandon any attempt to value such shares for income tax purposes, at least where the corporation is a frankly speculative enterprise. On the question of the limits to which the policy will be carried in cases where the speculative factor is not an element, there is little harmony in the decisions. A further pronouncement of the Supreme Court will be required before there can be any certainty as to the status of the law on this point.